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In The  
**Supreme Court of the United States**

CAPITAL ONE BANK (USA), N.A.,  
F/K/A CAPITAL ONE BANK, AND CAPITAL ONE, N.A.,  
AS SUCCESSOR TO CAPITAL ONE F.S.B.,

*Petitioners,*

v.

COMMISSIONER OF REVENUE  
OF MASSACHUSETTS,

*Respondent.*

**On Petition For A Writ Of Certiorari  
To The Supreme Judicial Court Of Massachusetts**

**BRIEF OF THE COMMONWEALTH OF  
VIRGINIA, JOINED BY SOUTH DAKOTA,  
AS AMICI CURIAE IN SUPPORT OF  
GRANTING THE PETITION FOR CERTIORARI**

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## **QUESTION PRESENTED**

Whether the Supreme Judicial Court of Massachusetts erred in holding that a State may evade the "substantial nexus" requirement as explicated in *Quill* and *Bellas Hess* by imposing an income or excise tax on the very same out-of-state corporations that are constitutionally immune from sales and use taxes because they lack a physical presence in the taxing State.

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## **INTEREST OF AMICI<sup>1</sup>**

The question presented in the petition is one of considerable importance and practical significance to the States. Under our constitutional design, the States bear the principal responsibility for the education, public safety, and transportation needs of the citizenry. Although States derive income from a variety of sources, taxes provide the lion's share of State revenues. Traditional taxation schemes have been battered by profound changes to the economy. These changes will prod States into reevaluating their taxation methods. Moreover, in the short and long-terms, States face growing challenges to align their spending commitments with their revenues. These challenges will provide further impetus for the States to reassess their revenue streams. In light of these challenges and pressures for taxation reform, the States need clarity in the law.

The amici States takes no position with respect to the underlying merits of the argument presented by Capital One. Rather, the States urge this Court to grant the petition so that the States can have the benefit of this Court's guidance regarding the "nexus" required by the Commerce Clause with respect to taxes imposed on an entity with no physical presence in a particular State.

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<sup>1</sup> Counsel for Virginia, by written letter, has informed counsel for the parties of its intent to file this brief.

## SUMMARY OF THE ARGUMENT

The Petition should be granted for three complementary reasons. First, the law is unclear. The lower courts are divided with respect to the "nexus" required under the Commerce Clause for a State to be able to impose a tax upon a corporation that lacks a physical presence in the State. Three state courts, including the lower court, uphold a tax based on a loose "nexus." An equal number of state court decisions cast doubt on these holdings. This uncertainty invites complex litigation and creates uncertainty concerning how States should reform their tax systems.

Second, the States have been, and will continue to be, compelled to reevaluate traditional taxation methods. The States are under great fiscal pressure due to the current recession. In the longer term, a growing gap between projected spending and projected revenues will force the States to consider new revenue streams, as well as cuts or changes in services. In addition, many state taxes are predicated upon increasingly superseded transactions for "brick and mortar" firms. The economy has undergone a profound transformation in recent decades and has moved away from these traditional business models. As the States consider what changes to make, the States need clarity in the law. At present, that clarity is missing.

Finally, the States need clarity because the consequences of an invalidated tax scheme, even one

enacted with the best of intentions, are profoundly disruptive to the States. If a state tax is found to be unconstitutional, the State loses the income stream from that tax. A State in that situation also must issue refunds for the improper taxes collected and deal with the ensuing morass of litigation. The consequences for guessing wrong on the required "nexus" could materially impact basic governmental functions.

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## ARGUMENT

### I. THIS COURT SHOULD CLARIFY THE EXISTING UNCERTAINTY ABOUT ANY RESTRICTIONS THE COMMERCE CLAUSE IMPOSES ON A STATE ASSESSING A CORPORATE TAX IN THE ABSENCE OF A PHYSICAL PRESENCE.

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court examined the propriety of a use tax on a company that sold office equipment and supplies in North Dakota via catalog, flyers and direct telephone calls. *Id.* at 302. The company also shipped diskettes to some customers. *Id.* at 315 n.8. Drawing from its decision in *Nat'l Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967), this Court concluded that North Dakota's use tax placed an unconstitutional burden on interstate commerce because Quill had no meaningful physical presence within the State. *Quill Corp.*, 504 U.S. at 312-19. The Court also concluded that the "slightest

presence" of the diskettes in the State did not constitute the "'substantial nexus' requirement of the Commerce Clause." *Id.* at 315 n.8. The precise scope of this decision—whether it should be circumscribed to sales and use taxes, or whether it applies to other state business activity taxes—has become an issue of great importance for the States and for taxpayers.

Currently, "most states impose a financial institution tax (FIT) on all banks or other financial institutions." 1-5 Melanie J. McDaniel, BENDER'S STATE TAXATION: PRINCIPLES AND PRACTICE § 5.05 (2009). "The issue that has developed in the realm of financial institution taxation is what nexus concept a state applies when imposing its FIT on banks." *Id.* The lower courts are divided on this important question. A growing number of States have adopted an economic-nexus approach with respect to assessing their FITs.<sup>2</sup> Although the economic-nexus theory has been extensively litigated with respect to FITs, a decision in this case would have broad

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<sup>2</sup> See *Indiana Code §§ 6-5.5-3-1, 6-5.5-3-4* (2006); *Kentucky Rev. Stat. Ann. § 136.520* (2006); *Massachusetts Gen. Laws ch. 63, § 1* (2006); *Minnesota Stat. § 290.015* (2006); *West Virginia Code § 11-24-7b* (2006). Effective January 1, 2008, New York adopted an "economic-nexus" for banks engaging in credit card transactions in the State. *New York Tax Law § 1451(c)(1)* (2009). On May 1, 2008, Oregon similarly adopted a regulation permitting taxes on credit card activity in the State. Or. Admin. R. 150-317.010 (2008).

implications in other areas of business activity that are taxed by the States.<sup>3</sup>

Three state courts have embraced a narrow reading of this Court's decisions in *Quill* and *Bellas Hess*. The Supreme Judicial Court of Massachusetts held "the constitutionality, under the commerce clause, of the Commonwealth's imposition of the [Financial Institution Excise Tax] is determined not by *Quill*'s physical presence test, but by the 'substantial nexus' test." *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76, 86 (Mass. 2009). The Supreme Court of West Virginia similarly concluded that *Quill* was limited to "sales and use taxes" and concluded that the "substantial nexus" required by the Commerce Clause could be satisfied by an "economic presence test." *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), cert. denied sub nom. *FIA Card Servs., N.A. v. Tax Comm'r of W. Va.*, 127 S. Ct. 2997 (2007). Finally, the Indiana Tax Court also concluded that *Quill* was limited to sales and use taxes and upheld Indiana's FIT based on a credit card company's "economic presence" in Indiana. *MBNA Am. Bank, N.A. v. Indiana Dep't of State Revenue*, 895 N.E.2d 140, 143-44 (2008).

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<sup>3</sup> See Pet. 31-33 (describing the recent adoption of an "economic nexus" for various taxes in New Hampshire, Michigan, California, Maine, Florida, and Oregon).

The decisions of other courts, however, reject a narrow reading of *Quill* and *Bellas Hess* and call into question the holdings above. In *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the Tennessee Court of Appeals concluded that a credit card issuer with no physical presence in the State could not be compelled to pay franchise and excise taxes. *Id.* at 842. The court concluded that *Quill* was controlling and could not be limited to sales and use taxes. *Id.* at 839-42. Similarly, the Texas Court of Appeals in examining a franchise tax, that “*Quill Corp.* and *Bellas Hess* should be limited to the context of sales and use taxes,” rejected the argument. *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 299 (Tex. App. 2000). In that court’s view, “no sufficient nexus exists to permit the state to assess [a] tax” in a situation where “the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state.” *Id.* at 300. Finally, the Michigan Court of Appeals addressed the issue in examining whether certain activities by a corporation outside of the State of Michigan could establish a nexus between the corporation and those States sufficient to avoid the Michigan single business tax. *Guardian Indus. Corp. v. Dep’t of Treasury*, 499 N.W.2d 349, 352-53 (Mich. Ct. App. 1993).<sup>4</sup> The court reasoned that, “after *Quill*,

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<sup>4</sup> The single business tax was “a consumption type value-added tax.” *Guardian*, 499 N.W.2d at 353. This tax was ultimately replaced in 2008 with the Michigan Business Tax. See Jeffrey Guilfoyle, Office of Revenue & Tax Analysis, Michigan Department  
(Continued on following page)

it is abundantly clear that [a corporation] must show a physical presence within a target state to establish a substantial nexus to it." *Id.* at 356. The court remanded the case for further factual development with respect to the corporation's physical presence in other States. *Id.* at 357-58.

This uncertainty exposes the States to complex ongoing litigation and uncertainty as to the ultimate validity of taxes like the FIT. Eight years ago, one commentator discussed the matter and noted that "the U.S. Supreme Court will be asked to resolve the issue." R. Todd Ervin, Comment, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?* 19 Va. Tax Rev. 515, 516 (2000). One treatise in 2003 noted that this issue presents a "conflict of controlling state authority on a critical constitutional issue involving nothing less than the ability of the states to impose taxes among competing taxpayers on a level playing field. This is an issue that cries out for resolution which can only come from the highest court of the nation." Paul J. Hartman & Charles A. Trost, *FEDERAL LIMITATIONS ON STATE AND LOCAL TAXATION* § 10:7 (2nd ed. 2003). In their 2008 supplement, the authors note that "the uncertainty continues." *Id.* (2008 Supp.). The time has come for this Court to grant certiorari and settle the question.

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of Treasury, *Overview of the Michigan Business Tax* (Sept. 2008). Available at: [http://www.taxadmin.org/fta/meet/08rev\\_est/papers/guilfoyle2.pdf](http://www.taxadmin.org/fta/meet/08rev_est/papers/guilfoyle2.pdf).

## **II. THE STATES NEED PREDICTABILITY AS THEY REASSESS THEIR INCOME STREAMS IN THE FACE OF SEVERE BUDGET PRESSURE AND A CHANGING ECONOMIC ENVIRONMENT.**

### **A. The States face short-term and long-term budget pressures.**

Present economic conditions impose great challenges to the state governments. The National Conference of State Legislatures noted in April 2008, in its State Budget Update, that, “[w]ith a few exceptions, state finances are deteriorating, in some cases considerably.”<sup>5</sup> The situation certainly has not improved since that report was prepared. Even if the present economic crisis were to subside rapidly, the States face long-term budgetary stress. A recent Government Accountability Office report details some of these long-term challenges. U.S. GOV’T. ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENTS, GROWING FISCAL CHALLENGES WILL EMERGE DURING THE NEXT 10 YEARS (Jan. 2008).<sup>6</sup> The GAO report concludes that

absent policy changes, state and local governments will face an increasing gap between receipts and expenditures in the coming years. Since most state and local governments actually face requirements that

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<sup>5</sup> Available at: <http://www.ncsl.org/programs/fiscal/sbu200804.htm>.

<sup>6</sup> Available at: <http://www.gao.gov/new.items/d08317.pdf>.

their operating budgets be balanced or nearly balanced in most years, the declining fiscal conditions our simulations suggest are really just a foreshadowing of the extent to which these governments will need to make substantial policy changes to avoid these potential growing fiscal imbalances.

*Id.* at 5. Although there are a number of causes for this gap, the primary driver for increased expenditures is the cost of delivering health care, notably for the Medicaid program and the health benefits for state and local employees. *Id.* These “long-term fiscal challenges . . . are exacerbated by the current recession.” U.S. GOV’T. ACCOUNTABILITY OFFICE, LETTER TO SEN. MAX BAUCUS, CHAIRMAN, AND CHARLES E. GRASSLEY, RANKING MEMBER, COMMITTEE ON FINANCE, UNITED STATES SENATE (Jan. 26, 2009).<sup>7</sup> To cover these expenditures, it is inevitable that many States, in addition to eliminating or cutting certain programs, will reassess their taxation schemes in an effort to pay for state services.

**B. The changing nature of commerce will continue to prompt the States to reassess their income tax structures.**

If the pressures described above did not suffice, fundamental changes to the economy make it more

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<sup>7</sup> Available at: <http://www.gao.gov/new.items/d09320r.pdf?source=ra>.

likely that States will reevaluate their taxation methods. Until recently, most financial services were provided by small, local, or regional banks. Now, large national financial institutions provide all manner of services to the public, including credit cards, investment and brokerage services, and mortgages. Financial institutions routinely transact business with residents of a state in which the financial institution has no physical presence.

These long-term structural changes are not limited to the financial sector of the economy. Instead of transacting business with a local telephone company, some companies providing telecommunications services now have national reach and no physical presence in most states. The tremendous growth of commerce over the Internet is another fundamental change in the way transactions of all kinds are conducted. Sales over the Internet continue to grow at a strong pace, even in the current economic environment.<sup>8</sup>

All of these changes will continue to have profound effects on the way states tax. "The rapidly increasing extent of multistate activity appears to have dramatically lowered state sales and corporate income tax bases by making it difficult for states to collect taxes on remote sales and by allowing firms

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<sup>8</sup> See National Retail Federation, *Online Sales to Climb Despite Struggling Economy* (April 8, 2008). Available at: [http://www.nrf.com/modules.php?name=News&op=viewlive&sp\\_id=499](http://www.nrf.com/modules.php?name=News&op=viewlive&sp_id=499).

greater opportunities to shift income to low or no tax states." William F. Fox, *The Ongoing Evolution of State Revenue Systems*, 88 MARQ. L. REV. 19, 38 (2004). Inescapably, the States will "seek to fix their traditional taxes, and particularly the sales and corporate income taxes, to offset the weaknesses arising from the causes described above." *Id.* at 43. Given these pressures, many other States will no doubt consider whether to adopt similar measures. The question presented should be resolved *before* a broad conception of "nexus" becomes more deeply embedded in the tax regimes of the States.

### **III. PREDICTABILITY IS CRUCIALLY IMPORTANT TO THE STATES BECAUSE THE CONSEQUENCES OF AN INVALIDATED TAX ARE EXTREMELY DISRUPTIVE.**

When a state tax is invalidated, the State will, of course, lose the income stream from the tax. Although some States have assembled a "rainy day" fund for certain contingencies, the limited resources in those funds may not be sufficient to cushion the blow. This particularly is true in the immediate future because state reserve funds currently are depleted. Furthermore, replacing the lost revenue stream with a new tax can take time due to the political process. Meanwhile, if the revenues are not quickly replaced, a State must reduce or eliminate services. Those most in need of services may bear the brunt of budget cuts. Furthermore, because most states have balanced

budget amendments, the option of deficit spending is not available.<sup>9</sup>

Adding to the loss of income are the lawsuits or refunds that follow in the wake of an invalidated tax. Thus, a State facing an invalidated tax faces a double blow. Not only does the State lose the income from that tax, it also must contend with refunds and lawsuits in connection with the invalidated tax scheme. Virginia experienced this situation when this Court invalidated Virginia's taxation of the retirement benefits of federal employees. *See Harper v. Virginia Department of Taxation*, 509 U.S. 86 (1993). At the time, refunds for approximately 200,000 claimants were estimated to total \$470 million, at a time when Virginia faced a projected revenue shortfall of \$700 million for its next biennium. *See Lonnie Harp, Tax Refund Ruling Clouds Fiscal Outlook for Some States*, EDUCATION WEEK (July 14, 1993).<sup>10</sup> The invalidation of a tax can be extraordinarily disruptive to a State.

States that do not presently rely upon the economic-nexus approach need this Court's guidance to gain an accurate and reliable understanding of what is and is not constitutionally permissible. The

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<sup>9</sup> See <http://www.ncsl.org/programs/fiscal/balreqs.htm> (discussing state balanced budget requirements).

<sup>10</sup> Available at: <http://www.edweek.org/ew/articles/1993/07/14/41refund.h12.html>. Ultimately, Virginia established a special fund and procedures to settle the claims. 1994 Va. Acts Spec. Sess. ch. 5.

States need this guidance *before* deciding whether to venture down that road and run the risk of subsequent invalidation, with all of the attendant disruption to revenues and services that this would entail.<sup>11</sup> The amici States ask this Court to grant certiorari to resolve the question presented.

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<sup>11</sup> A decision from this Court would also be beneficial for the States that have adopted an economic-nexus approach. Should the Court affirm the validity of the economic-nexus approach, it would forestall future challenges and place those taxes on a firm constitutional footing. If the Court invalidates business activity taxes based on an economic-nexus, given the clear trend toward the greater use of an economic-nexus approach in different areas of business activity taxation, the sooner the decision the less the potential for disruption.

## CONCLUSION

For the reasons stated above, the Petition for Certiorari should be **GRANTED**.

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